

## **EXECUTIVE SUMMARY**

Based upon a survey of the fifty states conducted by the firm of Kay, Casto & Chaney, PLLC, West Virginia stands out among the fifty states for the scope of its regulation of water and sewer utilities that are owned and operated by local government. Local government officials in most states make operational decisions for the water and sewer utilities they operate without state oversight. In West Virginia and only a few other states, publicly-owned water and sewer utilities are subject to nearly the same regulatory scheme applied to the service and rates of investor-owned utilities.

West Virginia's Public Service Commission regulates all public service district rates and regulates municipal rates upon petition. Only seven (7) other states regulate the rates of entities equivalent to public service districts. Similarly, seven states regulate the rates of municipal water and sewer utilities in some fashion. Indiana allows municipalities to exempt themselves from state regulation, and Mississippi and Pennsylvania only regulate with respect to non-residents of the municipality.

West Virginia, in addition to its rate regulation, also regulates publicly-owned utility operations, requiring advance approval for construction projects, borrowing of funds, sales of plant and equipment, and agreements with other utilities. Six (6) other states regulate construction by municipal utilities, although Mississippi and Pennsylvania limit their state's regulation of such projects to those affecting customers located outside of the municipality and Texas permits municipal utilities to waive approval requirements. A similar collection of states, seven (7) in total, require publicly-owned water and sewer utilities to seek state approval for other operations. Of these states, many do not regulate all activities subject to the same scope of prior approval as involved in West Virginia. As with rates and construction, Indiana municipal utilities may choose exemption and Mississippi and Pennsylvania municipal utilities are regulated only with respect to non-residents.

According to another recent study, the regulatory burden on publicly-owned water and sewer utilities in West Virginia appears likely to disadvantage state residents in receipt of reasonably-priced and quality utility services. Moody's Investment Service recently singled out West Virginia in a report on publicly-owned utility regulation for the state's obstacles to necessary revenue increases and facility maintenance or upgrades. A review of state practices across the country indicates that other states have overwhelmingly chosen to achieve appropriate utility practices by permitting local control of most publicly-owned water and sewer utilities.

# **REGULATION OF PUBLICLY-OWNED WATER AND SEWER UTILITIES**

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**OCTOBER, 2014**

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## **REGULATION OF PUBLICLY-OWNED WATER AND SEWER UTILITIES**

*"One of the major difficulties encountered by West Virginia in the regulation of municipally owned water systems has been the failure of the utilities to set aside a sufficient depreciation reserve to enable them to make replacements made necessary by the wearing out or obsolescence of equipment or facilities."*  
Myron R. Renick, Chairman of the Public Service Commission of West Virginia, October 29, 1959.<sup>1</sup>

Nearly fifty-five (55) years since Commissioner Renick shared his comments with the West Virginia Section of the American Water Works Association on the matter of utility financing in West Virginia, the same statement concerning the need for publicly-owned utilities to set aside sufficient reserves to make necessary repairs and replacements of their systems remains a major area of concern for those utilities. The difficulty faced by those utilities to set aside such reserves has led to their desire to examine whether the scope of regulation in West Virginia is consistent with that in other states, and whether certain adjustments in the scope of such regulation may be warranted.

The firm of Kay Casto & Chaney, PLLC was retained by the West Virginia Rural Water Association, the West Virginia Municipal Water Quality Association, the West Virginia Section of the American Water Works Association, and the West Virginia Water Environment Association to review the extent to which publicly-owned water and sewer utilities are regulated by state government in states other than West Virginia. The results of that investigation are incorporated in this report.

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<sup>1</sup> *Rate-Making Regulations and Financing in West Virginia.* Paper presented at the West Virginia Section of the American Water Works Association in Parkersburg, appearing in the March, 1960 Journal of the American Water Works Association, Volume 52, Issue 2 at page 308. See Exhibit 1 attached hereto.

## UTILITY REGULATION IN WEST VIRGINIA

In order to appreciate the scope of regulation in West Virginia in relation to that experienced in other states, it is important to first understand the extent of regulation experienced by publicly-owned utilities (public service districts and municipalities) in West Virginia.

### Rates

The rates of all public service districts located in each of the state's 55 counties, are regulated under the provisions of *West Virginia Code §24-2-4a*, similarly to the regulation of rates of privately-owned public utilities. Since June 30, 1981, the time for the Public Service Commission ("Commission") to decide a rate filing has been dependent upon the number of customers served by the utility. Until the passage of HB 4601 during the 2014 legislative session, rate increases were subject to suspension for a period of time based upon the number of customers served. HB 4601 amended *West Virginia Code §24-2-4a* and eliminated the suspension period for rate increases of less than 25% of gross revenues and permits rates to go into effect upon filing, subject to refund. Rate increases of more than 25% continue to be suspended for the period of time set forth in the statute unless a waiver is granted by the Commission. The time period for establishing final rates remains the same as the time of the suspension period based upon the number of customers served.<sup>2</sup> Given the fact that most public service districts serve less than 7,500 customers, the Commission is permitted to take between 120 to 180 days to establish permanent rates after the filing of a proposed rate increase. In August, 2013, in response to concerns raised by the Berkeley County Water and Sewer Public Service Districts, the Commission established a new policy applicable to the three or four districts that serve more than 7,500 customers that when applied will shorten the suspension period for those utilities to 180 days.<sup>3</sup> In practice, other than the policy informally established in August, 2013, the Commission typically

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<sup>2</sup> Code §24-2-4a authorizes the Commission to suspend rates for a period of 120 days for utilities serving 2,500 customers or less; 150 days for those serving between 2,500 and 5,000 customers; and, 180 days for those serving between 5,000 and 7,500 customers. For any district with more than 7,500 customers, the Commission can take up to 270 days to establish permanent rates. If the Commission has not established permanent rates at the end of the suspension period, the utility's proposed rates shall become effective until changed by the Commission.

<sup>3</sup> See letter from the Commission's General Counsel to Senators Unger and Snyder dated August 20, 2013 attached hereto as Exhibit 2.

does not permit final rates to go into effect prior to the end of the suspension period set forth in the *Code* and it is unknown what effect H.B. 4601 will have on the time period for implementation of final rates.

In order to initiate a rate increase through a tariff filing, public service districts, like all private utilities are required to file an accounting exhibit in support of their proposal. This exhibit is based upon the results of the utility's most recently concluded fiscal year and must follow the requirements of Rule 42 of the Commission's *Rules for the Construction and Filing of Tariffs*.<sup>4</sup> Because of the extensive accounting requirements, virtually all utilities hire CPA's to prepare their Rule 42 Exhibits.

Rates of all West Virginia municipal utilities providing water and sewer service are also subject to regulation by the Commission. However, since 1979, the rates of municipalities have been regulated by the Commission only upon a timely petition being filed with the Commission within thirty (30) days of the adoption of a municipal rate ordinance.<sup>5</sup> The Commission's jurisdiction over municipal rate changes is triggered by receipt of a timely-filed petition for review. After receipt of such a petition the Commission has 120 days from the date that the rates would otherwise take effect to review the rates adopted by the municipality; regardless of the number of customers served.<sup>6</sup> When the Commission's review is triggered, it establishes rates in a manner similar to that followed by the Commission for privately-owned utilities. Municipal utilities are not required to provide the Commission with the same accounting Rule 42 Exhibit in support for their proposed rates as are public service districts. However, in

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<sup>4</sup> The Commission has an alternate rate procedure for small utilities with less than \$1,000,000 in gross annual revenues which does not require the filing of a Rule 42 Exhibit. However, the time periods in the statute do not cover these filings and the time for Commission review can, and sometimes does, exceed the time limits provided for tariff filings.

<sup>5</sup> H.B. 4601 also eliminated the suspension period of rate increases for municipalities for increases of less than 25% of gross revenues, and authorized the Commission to waive the suspension period for increases of 25%. The revision to *Code* §24-2-4b also permits municipalities to put increases into effect on the date stated in the ordinance. Previously, rates could not become effective until 45 days after adoption of the rate ordinance. Regulations to carry those statutory changes into effect are under consideration of the Commission at the time of the submission of this report. (See, Public Service Commission General Order 183.07)

<sup>6</sup> Thus, unlike the timing for the finalization of rates for public service districts with more than 2,500 customers, all municipalities are treated the same regardless of the number of customers. Also, the Commission typically does not permit the permanent rates to be placed into effect until the end of the suspension period.

conducting its review, the Commission's Staff does follow Rule 42 and conducts its own cost of service studies.

Much of the tension between the publicly-owned utilities and the Commission with regard to ratemaking stems from the fact that the Commission's rate determinations are made on the basis of an historical test period. The historical test period is generally the most recent fiscal year for the utility. While the Commission does permit the utility to propose rates based upon "known and measureable" adjustments to the test year, the combination of the historical test year and the length of time it takes to arrive at a final rate determination often leave the utility with less revenue than the Commission's order contemplates.

An example that helps to explain this situation can be seen where a public service district serving more than 2,500 customers but less than 5,000 files for a rate increase on June 1, 2014, based upon a test year ended June 30, 2013. In that case, the Commission is entitled to take up to 150 days to decide the rate filing; meaning, that final rates will not be known until November 1, 2014. Given the fact that rates approved on November 1, 2014 cannot be placed into effect until sometime in December, 2014 (based on service rendered on or after November 1, 2014), and the receipts from December bills will not be received until sometime in January or February depending upon billing cycles, the district would not receive the first full month of permanent rates until 270 days after filing (June, 2014 through February, 2015), and 500 days after the close of the test year (July, 2013 through February, 2015). Also, while the Commission does make adjustments for known and measurable changes for increases in cost of service such as salary increases or increases in chemical costs that occur after the test year and before the Staff's recommendation is made to the Commission; usually 60 or more days prior to the Commission's order (say, September 1, 2014 in the example given), the approved rates will not include revenues sufficient to cover cost increases that occur between September 1, 2014 and the date the utility receives its permanent rate increase; February, 2015. Thus, increases in items of the utility's cost of service such as electric rate increases for the cost of operating pumps, chemical costs, or other items beyond the utility's control that occur after September 1, 2014 would not be covered by the Commission's method of rate making.

It is also frequently argued that the Commission's ratemaking philosophy fails to take into consideration the fact that the utilities have, in most cases, tried to keep from raising rates. By focusing on the amounts spent during the test year, the historical test year approach tends to discount the fact that utilities regularly delay repair and maintenance activities and staff additions in order to keep rates low. In those cases,

when the publicly-owned utilities do file a rate case with the Commission or adopt an ordinance to increase rates, the Commission establishes rates based upon the historical experience of the utility which involved inadequate spending and, because of the regulatory delay mentioned above, fails to provide the utility with sufficient surplus to change the course of the utility's decline.

As a result of this ratemaking scenario, city council members and public service district board members are subject to the uncomfortable criticism of their constituents when they are faced with a Commission decision that determines that the utility, in reliance upon the advice of engineering, accounting and legal consultants, has adopted rates that the Commission says are higher than needed, but which experience shows are necessary to meet their bond obligations and cover operation and maintenance expenses. The result of this super-management of publicly-owned utilities leads to the continued reluctance of publicly-owned utilities to increase rates in a timely fashion and the deterioration of utility facilities. It is often argued that, because of delayed maintenance and lack of sufficient finances, the customers of these utilities end up paying higher rates in the long run because of the inflationary costs associated with construction projects required to address repair and replacement items.

In addition to ratemaking, publicly-owned water and sewer utilities in West Virginia are regulated like all other public utilities in virtually all other respects and the Commission follows the same statutes and rules. Those areas of regulation include construction projects and activities that require prior Commission approval.

### **Construction projects**

One of the most common areas of interaction between publicly-owned utilities and the Commission in West Virginia involves approval for construction activities. *Code* §24-2-11 provides that, except for the construction of "ordinary extensions of existing systems in the usual course of business", all public utilities, including municipalities and public service districts, are required to obtain a certificate of convenience and necessity prior to the construction of any plant, equipment, property or facility for furnishing water or sewer service to the public. In such certificate cases, the Commission is authorized to take between 180 and 270 days to issue a final order.<sup>7</sup>

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<sup>7</sup> The shorter period of 180 days is applicable for projects that have been approved by the West Virginia Infrastructure and Jobs Development Council. See, *Code* §24-2-11(e).



This is an area of utility activity that was recognized by Commissioner Renick in his 1959 presentation to the AWWA as giving rise to the need of such utilities to set aside sufficient funds for repairs and replacements. In exercising its authority in this area, the Commission is required to determine that the project is necessary and the utilities have sufficient financing on reasonable terms to pay for the project and that the rates of the utility are sufficient to pay for debt service and make ongoing repairs and replacements to their systems. Projects that are subject to Commission approval are those where utilities are required to make substantial capital expenditures for such things as compliance with public health or environmental requirements required by the state or federal government as well as repair and upgrade of aging infrastructure. In order to obtain a certificate, the utility must file supporting engineering and accounting information in the form of Rule 42. Thus, it is necessary for publicly-owned utilities to hire attorneys, engineers and accountants to present their cases to the Commission for approval.

#### **Acts that require prior Commission approval**

All public utilities in West Virginia, including publicly-owned utilities, are required to obtain advance approval for: entry into contracts with other utilities for, among other things, the purchase or sale of the regulated commodity (e.g. water or sewage treatment); operation and maintenance of the public utility; or, for the transfer, merger, or consolidation of public utility plant, property or equipment. (See, *Code* §24-2-12)

Unlike all other public utilities, public service districts must also obtain Commission approval to borrow money, enter into contracts for the provision of engineering, design or feasibility studies, issue or contract to issue revenue bonds, or accept grants. (See, *Code* §§16-13A-24 and 25) Further, before filing for Commission approval, public service districts are required to obtain prior approval of their County Commissions for enlarging, reducing, merging, consolidating, or dissolving public service districts. (See, *Code* §16-13A-2)

## UTILITY REGULATION IN STATES OTHER THAN WEST VIRGINIA<sup>8</sup>

The research conducted by Kay Casto & Chaney, PLLC establishes that only eleven (11) states<sup>9</sup> have any form of regulation of publicly-owned utilities at the state level. However, the extent of regulation of publicly-owned utilities in the 11 states is not as extensive as that in West Virginia. In most states, rates and practices of publicly-owned water and sewer utilities are regulated at the local level by the municipality or the board of the agency providing service. In order to determine the relative degree of regulation in states other than West Virginia, the same categories of regulation (rates, construction projects, and other activities that require advance approval) were investigated.

### Rates

Only seven (7) states regulate municipal utility rates.<sup>10</sup> Of the seven, Indiana regulates municipal water rates but not sewer rates. However, Indiana municipal water utilities may remove themselves from regulation by the Indiana Utility Regulatory Commission by ordinance or by a majority vote of the residents.

Maine also regulates the rates of municipal water utilities, but not sewer utilities.

Mississippi and Pennsylvania regulate the rates of municipalities only for service of customers located outside of the municipal boundaries. In Mississippi, rate regulation only occurs for service to customers more than one mile outside municipal boundaries.

Rhode Island regulates the rates of municipal water utilities with more than 1,500 taps and sales of more than 10% outside of the municipal boundaries. A total of five (5) municipal utilities are regulated. Municipal sewer utility rates are not regulated at the state level.

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<sup>8</sup> The information contained in this section, and the spreadsheet attached hereto as Exhibit 3 is the result of information provided through statutory review and contacts with each of the state regulatory commissions. A copy of the form used to summarize each state's results is attached hereto as Exhibit 4. Copies of each state summary are attached in alphabetical order in Exhibit 5.

<sup>9</sup> Alaska, Delaware, Indiana, Kentucky, Maine, Mississippi, New Jersey, Pennsylvania, Rhode Island, Texas, and Wisconsin.

<sup>10</sup> Indiana, Maine, Mississippi, Pennsylvania, Rhode Island, Texas, and Wisconsin.

The Texas Commission on Environmental Quality, until September 1, 2014, and the Texas Public Utility Commission thereafter, regulates the rates of municipal water and sewer utilities only if the utility serves customers outside of the municipal limits and 10% of those customers residing outside of the city limits protest the municipal rate.

Wisconsin regulates the rates of municipal water utilities and combined water and sewer utilities. However, sewer rates are only regulated upon request of the sewer utility.

Seven (7) states regulate the rates of publicly-owned utilities similar to public service districts.<sup>11</sup>

Indiana has authority to regulate water conservancy districts. However, currently only one such district is regulated.

The Kentucky Public Service Commission regulates the rates of water districts, but not utilities controlled by political subdivisions. The commission's jurisdiction over sewer utilities is limited to wholesale rates.

Maine regulates the rates of quasi-municipal water districts, but not sewer utilities. Quasi-municipal water districts are formed to operate municipal water utilities. Their trustees are approved by district or municipal voters or are appointed by municipal officers as determined by their charters.

In Mississippi, Water and Sewer Districts and Public Improvement Districts created by local and private legislation to serve areas outside of municipalities are subject to the rate jurisdiction of the Mississippi Public Service Commission only if jurisdiction is conferred in the Act establishing the utility. Most such districts are exempt from rate jurisdiction. Districts are also created by County Boards of Supervisors, and these Districts are exempt from rate jurisdiction.

Rhode Island regulates the rates of a sewer utility, the Narragansett Bay Water Quality Management District Commission, and the Kent County Water Authority as the only non-municipal publicly-owned utilities regulated at the state level.

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<sup>11</sup> Indiana, Kentucky, Maine, Mississippi, Rhode Island, Texas, and Wisconsin.

The Texas Commission on Environmental Quality, until September 1, 2014, and the Texas Public Utility Commission thereafter, regulates the rates of various districts including Water Control and Improvement Districts and Special Utility Districts.

Wisconsin regulates the rates of all water utilities.

The extent of rate regulation in other states is, generally speaking, not as extensive as is the case in West Virginia. One recent study performed by Moody's Investor Service investigated rate experience in the eight (8) states that regulate the rates of publicly-owned utilities and found that, out of all of the states, the extent of regulation in West Virginia posed the highest obstacles to water and sewer rate increases of any of those states.<sup>12</sup> According to the Moody's study:

**West Virginia's rate approval process is arduous, lengthy, and elevates risks to bondholders.** Utilities in West Virginia face significant obstacles to increasing rates, leading to weaker debt service coverage, less revenue predictability, and a higher likelihood of breaking rate covenants. (Emphasis as in original)<sup>13</sup>

The Moody's study also observed generally that:

Rate limitations can make it difficult to increase revenues, upgrade infrastructure to comply with federal and state environmental regulations, engage in long-term financial planning, and meet rate covenants. If the funding sources for capital upgrades are unclear, utilities that need rate approvals can face difficulties in designing their capital improvement plans.<sup>14</sup>

Finally, in discussing the nature and extent of West Virginia's regulation of publicly-owned utilities, Moody's had the following sobering observations:

Water and sewer utilities in West Virginia must give 30 days' notice before filing for a rate increase. The rate case can take up to 270 days. The

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<sup>12</sup> Seymour, *Most US Municipal Utilities Enjoy Unlimited Authority Over Rates*, Moody's Investors Service, Special Comment, August 19, 2014, page 3 of Exhibit 6 attached hereto.

<sup>13</sup> *Id.* at page 1.

<sup>14</sup> *Id.* at page 3.

protracted rate approval process means that most of the fiscal year will have elapsed by the time a rate increase is approved.

**Compounding matters, the PSC usually rejects the full requested increase, by a magnitude greater than other states that regulate water and sewer rates.** In the past three years, the PSC had published information about 39 utilities with annual revenues of at least \$1 million that have filed rate tariffs. **Of the 39 requests, the PSC only granted two in full, with aggregate rate approvals of less than 60% of requested revenues.** (Emphasis added)

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Beginning this year, the state has authorized utilities to enact emergency rate increases and begin collecting revenues while awaiting approval. This change addresses the cash-flow challenges concerning the lengthy wait for rate increase approvals. But the emergency rates are still subject to state approval: if the PSC rejects the emergency rate increase, utilities must then refund customers for the increased revenues. Given that the PSC has usually rejected portions of proposed rate increases, the emergency rate process might introduce new problems for utilities having to refund prior-year revenues collected from retroactively rejected emergency rate increases.

### **Construction projects**

Six (6) states regulate construction projects of municipalities to one extent or another.<sup>15</sup>

Delaware requires that municipal water and sewer utilities obtain a certificate of public convenience and necessity from the Delaware Public Service Commission for the construction or extension of new facilities.

Maine regulates the construction and extension projects of municipal water utilities including the issuance of debt for periods in excess of twelve (12) months.

Mississippi and Pennsylvania require approval of construction projects by water and sewer utilities for projects located outside of municipal boundaries.

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<sup>15</sup> Delaware, Maine, Mississippi, Pennsylvania, Texas, and Wisconsin.

Construction projects for water and wastewater facilities are subject to review by the Texas Commission on Environmental Quality, until September 1, 2014, and the Texas Public Utility Commission thereafter. Projects for repair and maintenance are subject to waiver upon request to the Commission.

The Wisconsin Commission regulates the construction of water projects costing \$250,000 or more or 25% of the prior year's operating revenues, whichever is less. However, approval is not required for repair projects or for the purchase of vehicles or movable equipment.

In addition to the six states that regulate construction activities of municipal utilities, those states also regulate construction activities of other publicly-owned utilities and two (2) additional states regulate the construction activities of other publicly-owned utilities.<sup>16</sup>

In Indiana, a municipal water utility may extend its service up to six miles beyond the boundaries of the municipality without Commission approval.

The Kentucky Public Service Commission fully regulates the construction and financing of projects for water districts.

#### **Acts that require prior approval**

Seven (7) states require some form of prior approval for certain activities.<sup>17</sup>

The Indiana commission has authority to regulate borrowing, agreements with other utilities, and the sale or transfer of property of municipalities and public service districts.

Kentucky has authority to approve borrowing, agreements with other utilities, and sales or transfer of property for water districts.

Maine has approval authority for borrowing, agreements with other utilities, and the sale or transfer of property for water utilities.

Mississippi requires approval of sale or transfer of utility property.

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<sup>16</sup> Indiana, and Kentucky.

<sup>17</sup> Indiana, Kentucky, Maine, Mississippi, Rhode Island, Texas, and Wisconsin.

Rhode Island and Wisconsin require publicly-owned water utilities that are subject to their commission's jurisdiction to obtain approval for borrowing, agreements with other utilities, and the sale or transfer of property.

Publicly-owned utilities in Texas are required to obtain approval for agreements with other utilities.

### **Other areas of regulation of publicly-owned utilities**

Other than the areas previously discussed, publicly-owned utilities in a number of other states are subject to some forms of regulation at the state level.

In Alaska, publicly-owned utilities are required to obtain a certificate of convenience and necessity to operate in a defined service area. Other forms of regulation of such utilities only come into play if the publicly-owned utility is engaged in competition with an investor-owned utility.

In Arizona, the corporations commission does not regulate publicly-owned utilities. However, such utilities are not permitted to provide service in an area for which a private utility is authorized to operate unless the commission has cancelled the authorization for the private utility.

Service areas of non-municipal public utilities – and municipal utilities seeking to extend more than one mile beyond municipal boundaries – are established by certificates of public convenience and necessity issued by the Mississippi Public Service Commission and some customer disputes involving municipalities are subject to resolution by that state's commission.

Municipal or county systems operating outside of their corporate limits in New Hampshire are subject to the jurisdiction of the public service commission for rate discrimination of non-residents. All regulation by the commission may be waived except for the approval of service territory.

The New Jersey Board of Public Utilities regulates service and reliability but publicly-owned utilities are not subject to economic regulation.

In New Mexico, publicly-owned water and sewer systems are typically not regulated. However, municipalities may elect to be regulated by the Public Regulation Commission. Further, municipalities attempting to extend service into an area served by a utility authorized by the Commission to serve may be required to elect regulation or will be denied the opportunity to extend service.

## **Conclusion**

Based upon the 50-state review conducted by the firm of Kay, Casto & Chaney, PLLC, it appears that there is no other state in which publicly-owned utilities are regulated as extensively as is the case in West Virginia. Further, based upon the conclusions reached in the recent Moody's Investment Services report referred to herein, rate regulation of publicly-owned utilities in West Virginia imposes the highest obstacles to rate increases of all of the states that regulate publicly-owned utility rates, making it "difficult for such utilities to increase revenues, upgrade infrastructure to comply with federal and state environmental regulations, engage in long-term financial planning and meet rate covenants."<sup>18</sup>

September, 2014

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<sup>18</sup> Seymour, *Most US Municipal Utilities Enjoy Unlimited Authority Over Rates*, Moody's Investors Service, Special Comment, August 19, 2014, page 3 of Exhibit 6.



# EXHIBIT 1

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## Rate-Making Regulations and Financing in West Virginia

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**Myron R. Renick**

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*A paper presented on Oct. 29, 1959, at the West Virginia Section Meeting, Parkersburg, W.Va., by Myron R. Renick, Chairman, West Virginia Public Service Com., Charleston, W.Va.*

**W**ITHIN the jurisdiction of the Public Service Commission of West Virginia, water utilities are divided into two distinct and separate classifications: (1) those owned and operated by political subdivisions of the state and (2) those privately owned. Most of those utilities operated by political subdivisions of the state are municipally owned and operated and usually serve customers within and adjacent to the municipality as well as customers within clearly defined public service districts created by the county courts. Such utilities operate tax-free, with the exception of certain federal excise taxes and a few specific federal payroll taxes, such as social security.

Both the publicly and privately owned utilities are dedicated to the public service. The obligation of rendering adequate service to customers rests with those charged with the responsibility for operation of the water system.

In order to render satisfactory service, water utilities must have sufficient gross income to pay their operating expenses and to provide sufficient reserve funds for the replacement of facilities through systematic application of fair and reasonable depreciation rates.

### **West Virginia Regulations**

West Virginia, instead of allowing a fair rate of return (as is done for privately owned utilities), allows a municipally owned utility to charge rates broad enough to produce sufficient funds to pay reasonable operating expenses (including depreciation), to service debt capital, and to provide sufficient surplus for needed additions or replacements.

One of the major difficulties encountered by West Virginia in the regulation of municipally owned water systems has been the failure of the utilities to set aside a sufficient depreciation reserve to enable them to make replacements made necessary by the wearing out or obsolescence of equipment or facilities. It should be pointed out that under West Virginia law, funds generated by a municipal corporation's operation of utility services may not legally be expended for any purposes other than those directly related to the operation of the utility.

### **Accounting Records**

In the matter of rate making, specific obligations fall by law directly upon the public service commission. The duty of determining the fairness and reasonableness of rates and charges for

services offered—in view of the investment in facilities, prevailing operating costs, proper allowances for depreciation, taxes, financing, and other pertinent factors, including the value of the service rendered—is the prime responsibility of the commission. Utilities are required to keep records, in account form, as prescribed by the commission. These records must cover buildings and equipment, operation costs, and financing, as set out in the uniform system of accounts for water utilities prescribed by the commission.

Only by keeping accurate accounting records are utilities able to be apprised of their financial condition at any given time and to supply the commission with required information. Such accounts provide a current standard against which the impact of changes in the economy can be measured.

Any utility has recourse to the commission. Its legal, engineering, and accounting facilities are available whenever:

1. Changes in rates and charges become necessary due to increased operating costs

2. Established rates and charges fail to provide sufficient revenue funds for a privately owned utility to pay necessary and reasonable operating expenses, provide for adequate depreciation reserves, pay applicable taxes, and provide a fair and reasonable return on investment

3. Established rates and charges fail to provide sufficient revenue funds for a publicly owned utility to cover reasonable operating expenses, provide reasonable reserves for depreciation and obsolescence, pay applicable taxes (usually social security taxes only), cover interest on outstanding bonds,

retire bonds in accordance with governing ordinances, and provide a reasonable reserve for contingencies.

A utility may, through its management, file an application for authority to change its rates and charges for service, or a new tariff, to become effective at a specified date at least 30 days from the filing date. In either case, the utility must file, or be in a position to file, complete statements and schedules covering its facilities in the public service and their original cost, as well as balance sheets and operating statements.

Following receipt of an application or tariff, the usual procedure is for the commission to set the case for hearing. At that time, the utility and the general public are given an opportunity to present such evidence as they may have to substantiate or protest against the application.

If a tariff is filed to become effective on a stated date the commission usually suspends the tariff for the maximum period allowable under the law (120 days) and institutes a proceeding in which the utility becomes respondent to the commission's order to show cause or justification for its tariff. In such cases the same accounting and financial statements are required. The burden of proof rests with the utility asserting the need for revision of rates and charges.

The facilities of the commission's engineering and accounting departments are usually utilized to provide the commission with information as to the condition and adequacy of facilities, valuation and estimated life of property, and a verification of the financial accounts presented.

Although there are many routine duties involved in the rate-making

process, there usually are, at the same time, many unusual situations which must be considered by the commission in an attempt to determine what information is relevant to a hearing.

### **Rate-Making Procedure**

There are at least four distinct steps in the rate-making procedure in West Virginia:

1. An application for authority to change rates and charges—and for a certificate of convenience and necessity, if the public utility is just starting operations—are presented to the public service commission.

2. A date is set for a hearing at which the applicant (or respondent) submits exhibits and gives testimony in support of the application or tariff. At the same time, protests, if any, are received.

3. Upon completion of the hearing, the case is referred to the accounting department for an examination of the books and records and a report of the audit is furnished to the commissioners.

4. The commission meets for the consideration of all of the evidence and for a final ruling.

In addition to the task assigned to the accounting department, the commission may—and does, with increasing frequency—call upon its engineering staff for studies and reports to be used in conjunction with those of the accounting department. Thus, there is a two-pronged approach to the problem of rate making. It is through the utili-

zation of all available facts that the commission can best determine just what constitutes a fair decision in a given case.

### **Financing of Improvements**

A privately owned public utility may obtain capital in one or more of several ways: (1) sale of common capital stock, (2) sale of preferred capital stock, (3) mortgage bonds, (4) notes, (5) internal financing from depreciation accruals, tax accruals, and from undistributed earnings.

Many factors are involved in the decision of what specific type of financing to use. Some of these are the effect of income and other tax regulations, policies of the federal government in supporting interest rates, and the demand for and availability of funds in the money market.

Other items which merit consideration are the financial condition of the utility, the history of its earnings, its dividend policy, the existing capital structure, and the possibility of growth.

Municipally owned utilities generally obtain funds for improvements from the sale of revenue or general obligation bonds, depreciation accruals, tax levies, and surplus. In view of the present and anticipated future condition of the money market, and the high prevailing discount rates, the time may well have arrived for municipally owned utilities to give serious consideration to the possibility of financing routine improvements and additions on a pay-as-you-go basis.

# EXHIBIT 2

## **Public Service Commission**

Richard E. Hitt, General Counsel



201 Brooks Street, P.O. Box 812  
Charleston, West Virginia 25323

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August 20, 2013

The Honorable John R. Unger II  
West Virginia Senate Majority Leader  
Room 227M, Building 1  
State Capitol Complex  
Charleston, West Virginia 25305

The Honorable Herb Snyder  
West Virginia Senate  
Room 217W, Building 1  
State Capitol Complex  
Charleston, West Virginia 25305

Dear Senators Unger and Snyder:

This is a follow up on possible changes to the way rate cases are processed by the Commission to address concerns expressed by representatives of the Berkeley County water and sewer Public Service Districts. The main concern addressed by the Districts is that because of their relatively large size based on number of customers served they, and two other large public service districts in the State, are subject to the same suspension period for requested rate increases as large private utility companies. The Districts suggested that their concern could be addressed by allowing them to initially set their own rates without going through the rate filing and approval process at the Commission.

We have considered several alternatives to the Berkeley County proposal, including shortening the processing time for rate cases. We do not believe that it is reasonable to reduce the processing time available to the Commission for rate cases involving large private utilities because of the complex rate case issues in those cases, such as rate base, capital structure, return on equity, rate of return, jurisdictional allocations and others. We believe that we can, however, reduce the rate case processing time for large public services districts. We believe this can be accomplished within our staffing and scheduling limits because there are very few districts the size of the Berkeley County PSDs, and the ratemaking issues for public service districts are not as numerous and complex as the issues for private utilities.

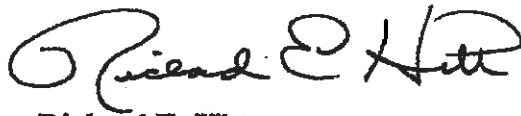
Under current law, the maximum suspension periods for tariff filings with a requested effective date of utilities serving over 7,500 customers is 270 days. The

Hoy G. Shingleton, Jr.  
August 20, 2013  
Page 2

Commission will implement a new policy to limit the suspension period to a maximum of 180 days for those Districts that have more than 7,500 customers and which timely file required financial information supporting requested rates. We will apply this policy to all cases filed by districts serving over 7,500 customers after the date of this letter. This shortening of the suspension period for the large public service districts to 180 days does not require statutory changes because the present law provides that suspension of tariff filings with a requested effective date for utilities serving more than 7,500 customers be for a period "not more than" 270 days.

The Commission will implement this policy immediately. We hope that you will find this approach to be a satisfactory effort to address the issues raised by the Berkeley County Districts. If you wish to address this matter further, please do not hesitate to contact me.

Sincerely,

A handwritten signature in black ink, appearing to read "Richard E. Hitt", written in a cursive style.

Richard E. Hitt  
General Counsel

cc: Hoy G. Shingleton, Jr., Esq.  
Rita Pauley, Chief Counsel to the Majority Leader, West Virginia Senate

# EXHIBIT 3



STATE	RATE REGULATION		CONSTRUCTION		BORROWING		AGREEMENTS WITH OTHER UTILITIES		SALES OF PROPERTY		
	Municipal	PSD	Municipal	PSD	Municipal	PSD	Municipal	PSD	Municipal	PSD	
Alabama											
Alaska											Regulated only when in competition with private utilities
Arizona											May not invade service territory of private company without approval
Arkansas											
California											
Colorado											
Connecticut											
Delaware			X	X							Some utilities must obtain Certificates of Public Convenience and Necessity
Florida											
Georgia											
Hawaii											
Idaho											
Illinois											
Indiana	X	X		X	X	X	X	X	X	X	Municipal water utilities may opt out of regulation. Sewer utilities are not regulated. Construction without approval permitted within 6 miles of boundaries.
Iowa											
Kansas											
Kentucky		X		X		X		X		X	
Louisiana											
Maine	X	X	X	X	X	X	X	X	X	X	Sewer utilities are not regulated.
Maryland											
Massachusetts											
Michigan											
Minnesota											
Mississippi	X	*	X	*		*		*	X	*	Only service areas of non-municipal public utilities created by county boards of supervisors are regulated. Asterisks used to indicate non-municipal public utilities created by special legislation may be subject to rate and other regulation - as prescribed by the legislation - but most are exempt. Municipal utilities' rates and service - including service area - are regulated where they extend more than one mile beyond boundaries.
Missouri											
Montana											
Nebraska											
Nevada											
New Hampshire											
New Jersey											Service and reliability are regulated, but publicly-owned utilities are not subject to economic regulation.
New Mexico											Municipalities may elect regulation. They may not extend service into a private service territory without approval.
New York											
North Carolina											
North Dakota											
Ohio											
Oklahoma											
Oregon											
Pennsylvania	X		X		X		X		X		Municipal utilities are subject to regulation for customers served outside boundaries.
Rhode Island	X	X			X	X	X	X	X	X	Only water utilities with >1500 connections and 10% of customers outside boundaries are regulated.
South Carolina											
South Dakota											
Tennessee											
Texas	X	X	X	X			X	X			Rates and service territories are regulated in varying forms based on utility circumstances.
Utah											
Vermont											
Virginia											
Washington											
West Virginia	X	X	X	X	X	X	X	X	X	X	
Wisconsin	X	X	X	X	X	X	X	X	X	X	Sewer utilities are not ordinarily regulated but may be upon request or complaint.
Wyoming											
TOTALS:	8	8	7	7	6	7	7	8	7	7	

# EXHIBIT 4

**[STATE]**

**Does a State Agency regulate publicly-owned water and sewer utilities?**

**[Yes or No and source, e.g. snippet statement from PSC site and Code citation defining utilities/regulatory authority and either definition/section exempting publicly-owned or defining utilities as investor-owned if public not regulated]**

**If yes, what type of systems are regulated:**

- **Municipally-owned systems?**
- **County-owned systems?**
- **Other public water or sewer authorities?**

**If yes, what type of regulation is undertaken:**

- **Rates?**
- **Construction projects?**
- **Financing?**
- **Acquisitions and sales of equipment or facilities?**

**If rates are regulated, what type of ratemaking regulation is used and when are rates determined or reviewed?**

**If rates are not ordinarily regulated, do any special circumstances such as a construction or extension case trigger rate regulation?**

**Do local or regional agencies regulate publicly-owned water and sewer utilities if not regulated by the State?**

1. Publicly owned water and sewer utilities. Please break it down by municipally owned, county owned, or other governmentally owned systems and break it down further by water or sewer and size. If the answer is no, please find out whether they know if any other state agency or local agency regulates such entities and what the basis is of such regulation; i.e. by number of customers, dollars of revenues or some other trigger. Please see if you can find the statutory basis for the extent of regulation.
2. If the State does regulate these utilities, please find out if they regulate rates, construction projects, financing, acquisitions and sales of equipment or facilities.
3. If the State regulates rates, please find out if the regulation is based upon rate of return rate-making or other form of regulation. If other form, what is that form? How are rates determined? Are there annual or other regular reviews, upon petition by the utility, upon complaint by customers or other forms of triggers. Does the State limit the size of such utility's surplus (surplus being defined as anything exceeding the cost to cover the cost of operations plus debt service and any debt service coverage requirement. If the State regulates the rates and considers a debt service coverage requirement, what is the level of coverage permitted? Is there a ceiling or a floor to such coverage level?
4. If the state does not regulate rates generally, does it regulate them in a construction or extension case? If yes, what triggers their regulation? Type of project, cost of project, revenues of the utility, other? Do they require approval of engineering contracts?
5. If the State does not regulate either rates or construction or extension projects of publicly owned utilities, are there other bodies in the state that do? E.g. County Commission, City agency or other.

# EXHIBIT 5

**INDIVIDUAL STATE SUMMARIES**

**NOT INCLUDED IN THIS COPY**

**IF DESIRED, COPIES MAY BE  
OBTAINED FROM  
ROBERT R. RODECKER**

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**304/391-8838**

# EXHIBIT 6

## SPECIAL COMMENT

Rate this Research &gt;&gt;

# Most US Municipal Utilities Enjoy Unlimited Authority Over Rates

Lack of Rate-Setting Authority a Potential Weakness for Utilities in Some States

## Table of Contents:

MUNICIPAL WATER AND SEWER UTILITIES WITH UNLIMITED RATE-SETTING AUTHORITY ENJOY CLEAR CREDIT ADVANTAGES

LIMITED RATE-SETTING AUTHORITY OCCASIONALLY HAMPER'S UTILITIES' CREDIT PROFILES

SOME RATE-APPROVAL REGIMES SELDOM LIMIT RATE INCREASES IN PRACTICE

WEST VIRGINIA'S RATE APPROVAL PROCESS IS ARDUOUS, LENGTHY, AND ELEVATES RISKS TO BONDHOLDERS

APPENDIX: ISSUERS WITH MATERIAL STATE OVERSIGHT OF WATER/SEWER RATES

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12

Most US municipal water and sewer utilities enjoy unlimited authority to set their own rates, a key credit strength. Municipal utilities whose rates are subject to approval by a regulatory body are at a credit disadvantage relative to utilities with unlimited rate-setting authority. Regulators in West Virginia, Pennsylvania, Wisconsin, Rhode Island and other states can take months to approve a water or sewer rate request and often do not grant proposed increases in full. Utilities in these states are more likely to violate rate covenants and face more uncertainty surrounding revenues compared with utilities with unlimited rate-setting authority.

We rate roughly 70 utilities with \$2.8 billion debt outstanding that face material regulatory constraints to increasing rates (see appendix), about 7.5% of our rated portfolio by number of borrowers and 2% of rated issuers' net debt. The median rating for these utilities is A1, a notch lower than the sector's median Aa3 rating. Rate-setting limitations are usually not a dominant credit risk, but are important factors for a small number of credits including [Berkeley County Public Service District](#), WV (A3 negative<sup>1</sup>); [Citizens Energy Group](#), IN (A2 stable); [Marinette Water Enterprise](#), WI (A3); and [Pennichuck Water Works](#), NH (Baa2 stable).

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Our key observations include:

**Municipal water and sewer utilities with unlimited rate-setting authority enjoy clear credit advantages.** Municipal water and sewer utilities in most states do not need approval to adjust rates. Unlimited rate-setting authority confers a stronger ability to comply with rate covenants, recover capital costs, plan for the long term, and increase revenues on short notice.

**Limited rate-setting authority occasionally hampers utilities' credit profiles.** A small number of utilities have endured credit stress because of limitations on rate-setting authority, occasionally leading to narrower debt service coverage, more risk of breaking covenants, and difficulty planning for the long term.

**Some rate-approval regimes seldom limit rate increases in practice.** One of the reasons credit stress rarely arises from state oversight of rates is that some of the states with a framework for rejecting rate increases often don't use it.

**West Virginia's rate approval process is arduous, lengthy, and elevates risks to bondholders.** Utilities in West Virginia face significant obstacles to increasing rates, leading to weaker debt service coverage, less revenue predictability, and a higher likelihood of breaking rate covenants.

<sup>1</sup> All ratings referred to in this piece are senior revenue ratings, unless otherwise specified.



## Municipal water and sewer utilities with unlimited rate-setting authority enjoy clear credit advantages

Unlimited and independent authority to set rates is a crucial [credit strength](#) underpinning the sector's strong median rating of Aa3. Most states<sup>2</sup> impose no limitation on or control of municipal water and sewer utilities' user rates.

Unlimited rate-setting authority confers clear credit advantages, including:

- » ability to increase rates on short notice if revenues fall short of expectations
- » stronger ability to meet rate covenants
- » greater ability to fund federal- and state- mandated capital upgrades to comply with environmental regulations
- » greater predictability of revenues, facilitating more effective long-term financial planning
- » better visibility into funding sources for capital improvement programs

Many utilities choose to give notice for rate increases, and hold hearings to allow for public objection. They do so voluntarily, however, and the authority to set rates ultimately resides with the governing board or a closely affiliated entity.

A key rating factor in our [proposed utility methodology](#) analysis is issuers' willingness and ability to adequately fund their systems with user rates. Unlimited rate-setting authority removes much of the "ability" component from the equation.

Importantly, just because utilities enjoy an unimpaired ability to increase rates does not mean they are willing to use it.

The [Jefferson County Sewer Enterprise](#), AL (unrated) and the [Oakdale City Sewer Enterprise](#), CA (B1) are the only two Moody's-rated municipal water or sewer utilities to [default](#) since 1970, and in neither case did a higher authority encumber their authority to set rates. In both cases, management failed to utilize their unlimited rate-setting authority for an extended period. In fact, both these utilities were able to enact large rate multi-year rate increases once they decided to<sup>3</sup>.

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on [www.moody's.com](http://www.moody's.com) for the most updated credit rating action information and rating history.

<sup>2</sup> [The District of Columbia Water and Sewer Authority](#) (Aa2 stable) and the [Puerto Rico Aqueduct and Sewer Authority](#) (Caa1 review for downgrade) also enjoy rate-setting autonomy.

<sup>3</sup> Oakdale's rate increases are subject to Proposition 218 objections (explained later), but we do not expect them to be problematic.

## Limited rate-setting authority occasionally hampers utilities' credit profiles

We have identified eight states with material obstacles to municipal water and sewer utility rate increases (see Exhibit 1). These limitations often make it more difficult to raise revenues quickly or as completely as utilities would like. Rated utilities subject to rate-setting limitations have a median rating of A1, a notch lower than the sector median of Aa3.

EXHIBIT 1

### States with Material Obstacles to Water/Sewer Rate Increases

States with material regulatory obstacles to water/sewer rate increases	Name of oversight body	Utilities without unlimited autonomy	Frequency of rate increase inhibitions	Severity of rate increase inhibitions
West Virginia	West Virginia Public Service Commission	Water and sewer	High	High
Pennsylvania	Pennsylvania Public Utility Commission	Utilities serving customers outside municipal boundaries	Low	Moderate
Rhode Island	Rhode Island Public Utilities Commission	Utilities serving customers outside municipal boundaries	High	Moderate
Mississippi	Mississippi Public Service Commission	Utilities serving customers more than 1 mile outside their boundaries	Low	Modest
Wisconsin	Public Service Commission of Wisconsin	Water only	Moderate	Moderate
Maine	Maine Public Utilities Commission	Water only	Low	Modest
Indiana	Indiana Utility Regulatory Commission	Water utilities that have not opted out of regulation	Low	Moderate
Kentucky	Kentucky Public Service Commission	County-created water districts, others only in limited contexts	Low	Moderate

Source: Moody's Investors Service

Rate limitations can make it difficult to increase revenues, upgrade infrastructure to comply with federal and state environmental regulations, engage in long-term financial planning, and meet rate covenants. If the funding sources for capital upgrades are unclear, utilities that need rate approvals can face difficulties in designing their capital improvement plans. Some states that require rate approvals allow utilities' revenues to become subject to political considerations, weighing the interests of many competing stakeholders. Rate cases that take more than a few months deprive utilities of the ability to raise revenues on short notice.

For utilities without rate-setting autonomy, we seek to answer the following questions:

- » How long does it take to gain approval for a rate increase?
- » How likely is the requested increase to be approved in full?
- » Does the regulator consider debt service in its rate cases?
- » Does the regulator consider bond covenants in its rate cases?
- » Are rate approvals based on the utility's costs, or does the state utilize a "reasonableness" standard that is vulnerable to arbitrariness?
- » Does the rate-approval regime hamper the utility's ability to comply with federal and state environmental regulatory standards?

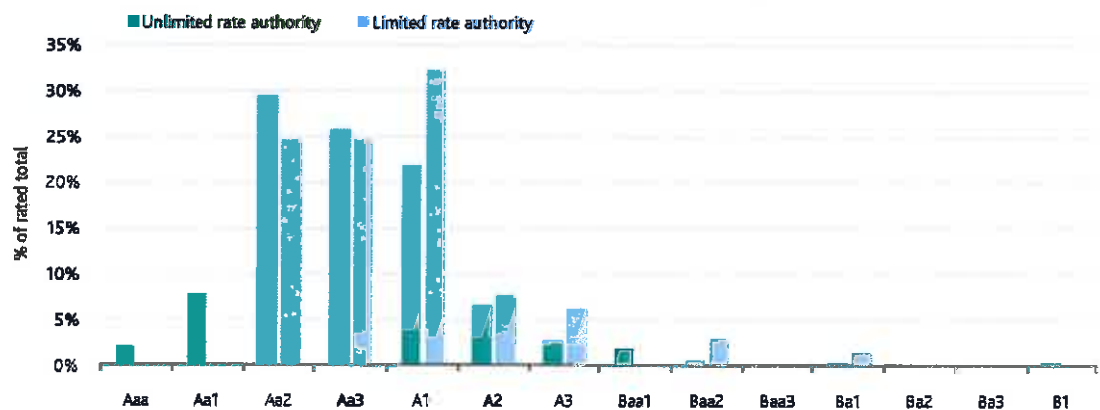
The importance of rate-setting authority heightens as a utility's financial pressures intensify. The inability to increase revenues on short notice is more detrimental for utilities with weak finances, and has played a role in the ratings for utilities with narrow debt service coverage such as the Marinette Water Enterprise, WI.

Even with rate-setting limitations, most water and sewer utilities are able to maintain healthy operations. We rate about 70 water and sewer utilities for whom the lack of rate autonomy is material (see appendix), or 7.5% of the sector, and most of these are still in the single- or double-A rating categories (see Exhibit 2).

EXHIBIT 2

### Most Utilities with Limited Rate Authority Still Have Strong Ratings

(Rating distribution for utilities with unlimited rate authority versus those with limitations)



Source: Moody's Investors Service

For most lower-rated water and sewer utilities on this list, the driving factor hasn't been the state impediments to rate increases but their own impediments. For example, the [Mequon Water Enterprise](#), WI (A2) has violated its rate covenant three times in the past four years, not because Wisconsin rejected the utility's proposed rate increases but because the utility over-projected customer growth. Similarly, the [North Jay Water District](#), ME (Baa2) has not raised rates since 2006 and has no plans to apply for a rate increase, even with net revenues currently insufficient to cover annual debt service.

Below we explore some of the states with the biggest regulatory obstacles to increasing rates.

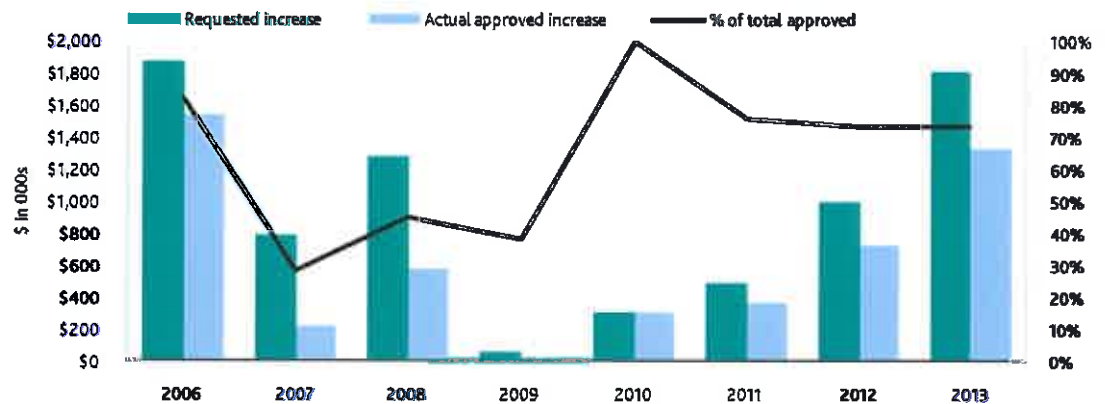
## Pennsylvania

The Pennsylvania Public Utility Commission (PUC) regulates rates that municipal utilities charge to customers outside their own boundaries. Although most utilities in the commonwealth do not serve outside customers and are not subject to PUC approvals, the PUC presents credit hurdles for a number of regional providers such as the [City of Lancaster](#) (General Obligation rated A1) and the [Borough of Quakertown](#) (GO rated A1). Rate approvals can take nine months. The PUC seldom approves the full requested rate increase, with approvals averaging around 70% of the increased revenues sought (see Exhibit 3). Utilities that reach settlements for lower rate increases typically agree not to seek another rate increase for a few years, another credit-negative facet of this process.

EXHIBIT 3

### PA PUC Impedes Public Utility Rate Increases

(Aggregate results for public utility rate cases in PA)



Source: Pennsylvania Public Utility Commission

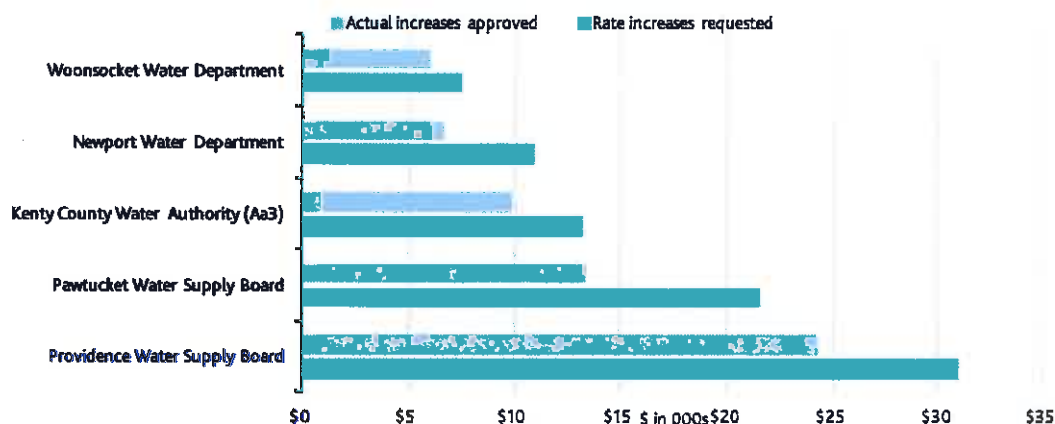
## Rhode Island

The Rhode Island Public Utilities Commission regulates the rates of five municipal water utilities and one sewer utility. Rate cases usually take six to nine months, which allows most of the fiscal year to elapse before a rate increase can begin generating new revenues. The sewer utility (Narragansett Bay Commission) has filed 15 rate cases since 2000, achieving 80% of the revenue increases it sought. The state's five water utilities, including the [Kent County Water Authority](#) (Aa3), have been comparably successful in their rate cases (see Exhibit 4).

## EXHIBIT 4

## Rhode Island Rejects Full Rate Increases

(Cumulative rate case outcomes for RI's 5 municipal water utilities since 2000)



Source: Rhode Island Public Utilities Commission

## Wisconsin

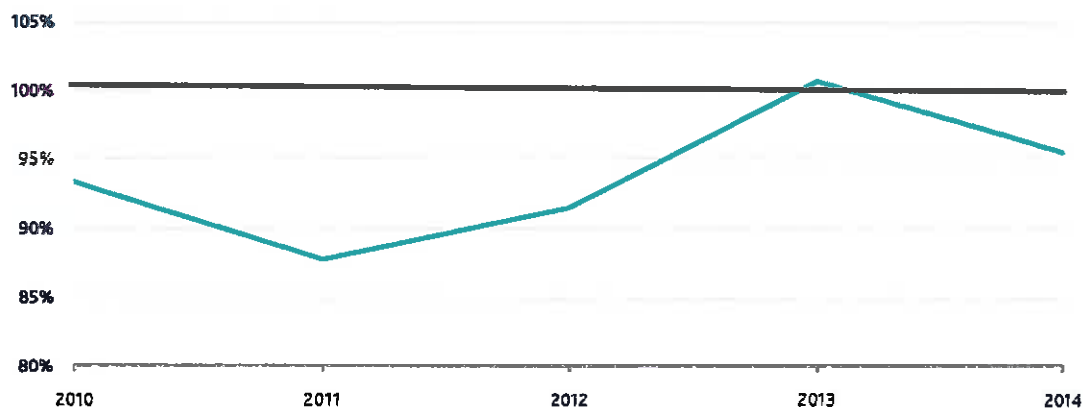
The Public Service Commission (PSC) of Wisconsin's rate approval process usually takes about five months and results in most or all of the requested increase being approved.

Under state law, a municipal water utility is entitled to a benchmark return on assets set at long-term bond rates plus a spread. On this basis, the state has approved 90% of all revenue-dollar increases requested since 2010 (see Exhibit 5). In fact, the commission often approves revenue increases higher than requested. Last year, the state's approved revenue increases exceeded those requested.

## EXHIBIT 5

## Wisconsin Approves Most Water Rate Requests

(% of water/sewer utility revenue dollar increases approved)



Source: Wisconsin Public Service Commission

Occasionally, rate increase proposals have faced delays. The [Appleton Water Enterprise](#), WI (Aa2) faced a lengthy delay for a requested rate increase in 2004, and the state deemed the utility ineligible for a rate increase in 2013 because the proposed rate of return exceeded the state benchmark. We downgraded the [Madison Water Enterprise](#), WI (Aa2 stable) last year as a result of severely depleted liquidity stemming from long delays in the approval and subsequent implementation of rate increases.

The utility's 9% rate increase request in October 2010 took seven months to approve, and was not fully implemented for 15 months.

Favorably, the PSC offers a simplified rate case process to request modest rate adjustments based on inflation. The Commission reports 164 filings for simplified rate cases in fiscals 2012 through 2013, with an average processing time of 34 days.

### Private utilities

Most states regulate the rates of private utilities, which can occasionally spill into the municipal utility sector in instances when the ownership or governance of a utility is ambiguous (see sidebar below).

Rate regulation by the Indiana Utility Regulatory Commission (IURC) is a key rating factor for the Citizens Energy Group, whose water revenue bonds we [downgraded](#) to A2 with a stable outlook last year in part because of its large outstanding rate cases. The utility's rate cases can take up to a year, and the IURC's rate criteria do not take the utility's bond covenants into account.

In April 2014, the IURC finally granted rate increases well below the those originally requested, citing executives' pay that is out of line with that of municipal systems and concerns about management practices.

#### Case Study: Pennichuck Water Works Inc., NH (Baa2)

When the City of Nashua, NH (Aa2 stable) purchased the publicly traded Pennichuck Corp. in 2012, it created a unique utility. The New Hampshire Public Utility Commission (NHPUC) regulates the rates of private utilities, but not public ones. The utility, now officially a corporation owned by one municipal shareholder, became a "municipal-like" water utility, serving Nashua and 10 surrounding communities, with rates subject to NHPUC regulation.

The NHPUC has consistently approved the utility's rate increases. However, the mechanisms for the Pennichuck Water Works to raise rates are limited compared with most municipal utilities. Rate cases can be presented no more than once every two years. The utility is entitled to charge rates sufficient to cover operating expenses plus the debt service on the city's acquisition debt. The credit strength of the utility remains limited by the lack of rate-setting autonomy that most municipal water systems enjoy.

### Some rate-approval regimes seldom limit rate increases in practice

One of the reasons limited rate-setting authority rarely applies credit stress to municipal utilities is that some of the states with a framework for rejecting rate increases often don't use it.

- » **California's** Proposition 218 regime allows for public objection to proposed rate increases (see sidebar), but we haven't seen them impede rate increases. A Prop 218 objection against a proposed rate increase by the [Sierra Madre Water Enterprise](#), CA (Ba1) failed this year, leading us to [confirm the utility's rating](#).
- » **Maine's** water rate approval process is lengthy at about nine months, but the state has passed legislation giving utilities several avenues to enact increases without state approval provided they meet certain conditions, weakening the practical barriers to rate increases.



- » Municipal utility rates in **Florida** are subject to a fairness standard, but we are not aware of the state ever rejecting or delaying proposed rate increases.
- » **Kentucky** does deny full rate increases to water districts sometimes, but the state has allowed frequent and reasonable rate increases for issuers such as the [Northern Kentucky Water District](#), KY (Aa3 stable).
- » The [Guam Waterworks Authority](#) (Ba1 positive) needs approval from the **Guam** Public Utilities Commission for rate increases, but the PUC has been supportive of increases, recently approving a five-year rate increase plan.
- » **Indiana** regulates municipal water rates, but has authorized municipal water utilities to withdraw from rate regulation. Most have. Of the state's 392 municipal water utilities, only 27 remain under state rate oversight (see Exhibit 6

## EXHIBIT 6

**Indiana Water Utilities Can Opt Out of Rate Regulation**

(Rated Indiana municipal water utilities)

Rate-regulated	Rating	Unregulated	Rating	Year of opt-out
Anderson Water Enterprise	A1	Crown Point Water Enterprise	Aa3	1990
Citizens Energy Group	A2	New Haven Water Enterprise	A2	1992
Fort Wayne Water Enterprise	Aa3			
South Bend Water Enterprise	Aa3			

Source: Indiana Utility Regulatory Commission, Moody's Investors Service

For those utilities that have not chosen to withdrawn from regulation, Indiana's rate oversight can be onerous. [The South Bend Water Enterprise](#), IN (Aa3) once waited 204 days for the IURC to approve an increase. Favorably, state law requires rates be sufficient to repay debt, and rates that are too low to meet operating requirements are unlawful, whether a utility's rate adjustments are regulated or not.

Also, seven states regulate only a subset of water and sewer utilities:

- » Pennsylvania and Rhode Island only have jurisdiction over rates charged by municipal utilities outside their own boundaries.
- » Mississippi only has jurisdiction over rates charged more than one mile outside municipal boundaries. This subjects a very small portion of the sector's rates to approval. For instance, fewer than 7% of the [Jackson Water and Sewer Enterprise](#), MS' (A1 negative) water accounts fall outside the 1-mile boundary.
- » Wisconsin, Indiana and Maine regulate the rates of water utilities but not sewer utilities.
- » Kentucky regulates rates of county-created water districts, with oversight over water or sewer rates otherwise applying only in very narrow contexts. The majority of water and sewer rates in the state are not regulated.

**Prop 218: Seldom a Practical Impediment to Rate Increases**

Proposition 218 blocks water and sewer rate increases in California only if a majority of ratepayers object, a level of public engagement seldom achieved.

Prop 218, which voters adopted as a constitutional amendment in 1996, requires local governments to obtain approval from a simple majority of ratepayers before levying new or increased assessments, fees or taxes. A 2006 state Supreme Court ruling found that the law applied to water and sewer charges.

The state requires utilities to notify and mail ballots to affected ratepayers 45 days before holding a public hearing regarding the proposed fee. In order for a proposed rate increase to be rejected, the utility must receive written protests from a majority of the affected ratepayers, requiring both a high response rate and a high degree of opposition.

Utilities rarely experience this magnitude of ratepayer opposition in practice, making the prospect of rejection a remote risk.

Even if a protest vote is not likely to succeed, however, the process still makes increasing rates more difficult and unlikely. The vote allows rate objections to gain momentum, and can prompt utilities to reconsider rate increases even if protest votes fall well short of the 50% threshold.

**West Virginia's rate approval process is arduous, lengthy, and elevates risks to bondholders**

The West Virginia Public Service Commission (PSC) imposes a lengthy and arduous rate approval process that erects serious obstacles to rate increases and is unfavorable to bondholders.

Water and sewer utilities in West Virginia must give 30 days notice before filing for a rate increase. The rate case can take up to 270 days. The protracted rate approval process means that most of the fiscal year will have elapsed by the time a rate increase is approved.

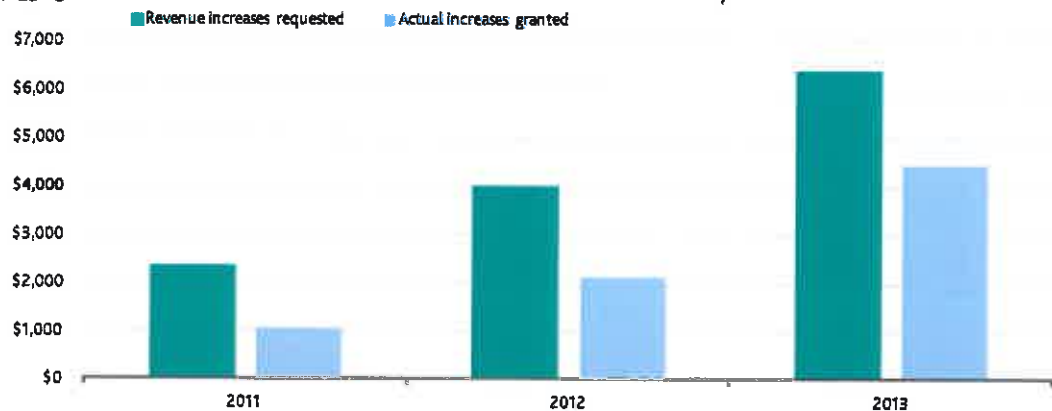
Compounding matters, the PSC usually rejects the full requested increase, by a magnitude greater than other states that regulate water and sewer rates. In the past three years, the PSC has published information about 39 utilities with annual revenues of at least \$1 million that have filed rate tariffs. Of the 39 requests, the PSC only granted two in full, with aggregate rate approvals of less than 60% of requested revenues (see Exhibit 7).



## EXHIBIT 7

**WV Seldom Approves Full Rate Increases**

(Aggregate rate case outcomes for utilities with at least \$1 million of annual revenues)



Source: West Virginia PSC

The Berkeley County Public Service District broke its rate covenant in 2012 and likely broke it again in 2014 chiefly because of its inability to win full rate increase approvals from the PSC (see sidebar).

The Friendly Public Service District filed a tariff request in September 2011 to unify some of its rates charged to residential and commercial customers, at no net change to annual revenues. The commission approved unifying customers' rates, but at a 3.7% decrease to revenues.

The PUC's reluctance to approve rate increases doesn't only crimp utilities' wherewithal to meet obligations to bondholders; it crimps their wherewithal to meet all kinds of obligations. The Jefferson County Public Service District requested a 14.9% rate increase in 2012 to pay an engineer that had worked on its wastewater treatment plant. During the rate hearings, the state at one point considered not only denying the rate increase, but decreasing the district's existing rates. Ultimately, the commission approved a settlement under which the amount owed to the engineer was reduced by more than \$200,000 (about 10% of the engineer's total fees on the project).

Beginning this year, the state has authorized utilities to enact emergency rate increases and begin collecting revenues while awaiting approval. This change addresses the cash-flow challenges concerning the lengthy wait for rate increase approvals. But the emergency rates are still subject to state approval: if the PSC rejects the emergency rate increase, utilities must then refund customers for the increased revenues. Given that the PSC has usually rejected portions of proposed rate increases, the emergency rate process might introduce new problems for utilities having to refund prior-year revenues collected from retroactively rejected emergency rate increases.

**Case Study: Berkeley County PSD (A3 negative)**

The West Virginia PSC presents a material obstacle for the Berkeley County PSD, which provides water to about 21,000 accounts in Berkeley County (Aa3). All rate adjustments in the state must obtain PSC approval, which has hindered the district from meeting its bond covenants and at times placed it in jeopardy of earning insufficient revenues to repay debt.

The PSC in 2005 authorized the district to issue a \$30 million Bond Anticipation Note and levy a capacity improvement fee (CIF) to pay it off. In 2012, with \$12 million still outstanding on the BAN, the PSC revoked the CIF authorization.

Without the CIF, the district broke its rate covenant for fiscal 2012 (ending 6/30/2012) and it was not clear it could earn enough net revenue meet the coverage covenant on bonds issued to take out its BAN.

The district filed a rate case in January 2013 asking for a 5% emergency rate increase, and ultimately a 19.5% rate increase.

The PSC took four months to reject the emergency rate increase, and more than nine months to approve an increase of just 15.3%. The district complied with its covenant in fiscal 2013 because of customer growth, but expects to break it again in fiscal 2014.

## Appendix: Issuers with Material State Oversight of Water/Sewer Rates

(Note: Some issuers, particularly in Kentucky, must get approval to adjust rates for some customers, but are excluded from this list as those customers represent an immaterial share of total revenues.)

Issuer	State	Rating	Oversight body
Guam Waterworks Authority	GU	Ba1 positive	Guam Public Utilities Commission
Anderson Water Enterprise	IN	A1	Indiana Utility Regulatory Commission
Fort Wayne Water Enterprise	IN	Aa3	Indiana Utility Regulatory Commission
South Bend Water Enterprise	IN	Aa3	Indiana Utility Regulatory Commission
Citizens Energy Group	IN	A2 stable	Indiana Utility Regulatory Commission
Boone County Water District	KY	Aa2	Kentucky Public Service Commission
Boone-Florence Water Commission	KY	Aa3	Kentucky Public Service Commission
Christian County Water District	KY	A2	Kentucky Public Service Commission
Hardin County Water District 1	KY	A1	Kentucky Public Service Commission
Hardin County Water District 2	KY	Aa3	Kentucky Public Service Commission
Northern Kentucky Water District	KY	Aa3 stable	Kentucky Public Service Commission
Ohio County Water District	KY	A2	Kentucky Public Service Commission
Kennebec Water District	ME	A1	Maine Public Utilities Commission
North Jay Water District	ME	Baa2	Maine Public Utilities Commission
Portland Water District	ME	A1	Maine Public Utilities Commission
Rumford Water District	ME	A2	Maine Public Utilities Commission
South Berwick Water District	ME	A1	Maine Public Utilities Commission
Jackson Water and Sewer Enterprise	MS	A1 negative	Mississippi Public Service Commission
Pennichuck Water Works	NH	Baa2 stable	New Hampshire Public Utilities Commission
City of Lancaster	PA	A1 (GO)	Pennsylvania Public Utility Commission
Borough of Quakertown	PA	A1 (GO)	Pennsylvania Public Utility Commission
Kent County Water Authority	RI	Aa3	Rhode Island Public Utilities Commission
Appleton Water Enterprise	WI	Aa2	Public Service Commission of Wisconsin
De Pere Water Enterprise	WI	Aa2	Public Service Commission of Wisconsin
Delavan Water Enterprise	WI	A1	Public Service Commission of Wisconsin
Eau Claire Water Enterprise	WI	Aa2	Public Service Commission of Wisconsin
Fond Du Lac Water Enterprise	WI	A1	Public Service Commission of Wisconsin
Germantown Water Enterprise	WI	Aa2	Public Service Commission of Wisconsin
Green Bay Water Enterprise	WI	Aa2	Public Service Commission of Wisconsin
Kaukauna Water Enterprise	WI	A1	Public Service Commission of Wisconsin
Kenosha Water Enterprise	WI	Aa2 stable	Public Service Commission of Wisconsin
Madison Water Enterprise	WI	Aa2 stable	Public Service Commission of Wisconsin
Manitowoc Water Enterprise	WI	Aa2	Public Service Commission of Wisconsin
Marinette Water Enterprise	WI	A3	Public Service Commission of Wisconsin
Marshfield Water Enterprise	WI	Aa3	Public Service Commission of Wisconsin
Menomonee Falls Water Enterprise	WI	Aa3	Public Service Commission of Wisconsin
Mequon Water Enterprise	WI	A2	Public Service Commission of Wisconsin

Muskego Water Enterprise	WI	Aa3	Public Service Commission of Wisconsin
Neenah Water Enterprise	WI	Aa2	Public Service Commission of Wisconsin
New Berlin Water Enterprise	WI	Aa2	Public Service Commission of Wisconsin
Oak Creek Water Enterprise	WI	Aa2	Public Service Commission of Wisconsin
Osceola Water Enterprise	WI	A3	Public Service Commission of Wisconsin
Oshkosh Water Enterprise	WI	Aa3	Public Service Commission of Wisconsin
Pewaukee Waterworks Enterprise	WI	A1	Public Service Commission of Wisconsin
Plover Water Enterprise	WI	A1	Public Service Commission of Wisconsin
Port Washington Water Enterprise	WI	A1	Public Service Commission of Wisconsin
River Falls Water Enterprise	WI	A1	Public Service Commission of Wisconsin
Sheboygan Water Enterprise	WI	Aa2	Public Service Commission of Wisconsin
Stoughton Waterworks System	WI	A1	Public Service Commission of Wisconsin
Sussex Water Enterprise	WI	A1	Public Service Commission of Wisconsin
Watertown Water Enterprise	WI	Aa3	Public Service Commission of Wisconsin
Waukesha Water Enterprise	WI	Aa2	Public Service Commission of Wisconsin
Wauwatosa Water Enterprise	WI	Aa2	Public Service Commission of Wisconsin
West Bend Water Enterprise	WI	Aa2	Public Service Commission of Wisconsin
Weston Water Enterprise	WI	Aa3	Public Service Commission of Wisconsin
Whitewater Water Enterprise	WI	A1	Public Service Commission of Wisconsin
Caledonia Water and Sewer Enterprise	WI	A1	Public Service Commission of Wisconsin
Cudahy Water and Sewer Enterprise	WI	A2	Public Service Commission of Wisconsin
DeForest Water and Sewer Enterprise	WI	Aa3	Public Service Commission of Wisconsin
Grafton Water and Sewer Enterprise	WI	Aa3	Public Service Commission of Wisconsin
Menasha Water and Sewer Enterprise	WI	A1	Public Service Commission of Wisconsin
Mount Horeb Water and Sewer Enterprise	WI	A1	Public Service Commission of Wisconsin
Mukwonago Water and Sewer Enterprise	WI	A1	Public Service Commission of Wisconsin
New Richmond Water and Sewer Enterprise	WI	A1	Public Service Commission of Wisconsin
Onalaska Water and Sewer Enterprise	WI	Aa3	Public Service Commission of Wisconsin
Verona Water and Sewer Enterprise	WI	Aa3	Public Service Commission of Wisconsin
Berkeley County Public Service District	WV	A3 negative	West Virginia Public Service Commission

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